Study H-857 February 4, 2009

First Supplement to Memorandum 2009-14

Small Associations (Public Comment)

Memorandum 2009-14 introduces the study of whether the law should distinguish between common interest developments (CIDs) of different sizes, in order to provide streamlined procedures for small associations. The Commission has received a number of comments on that memorandum, which are attached in the Exhibit to this supplement as follows:

The staff also received informal input from Martin Gorfinkel of Mountain View, Frank Roberts of Palo Alto, and Dick Preuss of the Community Associations Institute.

While Craig Stevens comments on issues relating to small associations, he limits his comments to small *nonresidential* CIDs. See Exhibit p. 16.

GENERAL REACTION

There seems to be considerable interest in this study. In a relatively short time, we have received comment from eight persons, half of them individual homeowners.

The commenters are generally supportive of the goals of the study:

> The investigation by the Commission into the separation of "small" and "large" associations in common interest developments (CIDs) is long overdue and is very welcome.

Samuel Dolnick, Exhibit p. 3.

> In general I support the notion that there should be some type of gradient compliance system. The one size fits all model is clearly costly and inappropriate in many cases.

Don Haney, Exhibit p. 8.

> Thank you for forwarding Memorandum 2009-14. I was pleased to hear that the Commission staff will study the application of the Davis-Stirling Act to "small associations".
>
> The Commission's acknowledgment that application of a "one-size-fits-all" statutory scheme can create problems for small common interest developments is very important.
>
> …
>
> Memorandum 2009-14 discusses how some of the requirements in the Davis-Stirling Act can be very burdensome for small associations. That is certainly correct insofar as the demand which it placed on association revenues. However, the Act may also discourage people from serving as directors of their homeowners association. I believe that because it frequently is difficult to find people who are willing to volunteer on behalf of their neighborhood. Recent changes to the Act have substantially increased duties of the board of directors and the tasks which the association must perform. While a master planned community might be able to afford professional management that is not the case with small associations.

Stephen Dyer, Exhibit p. 11.

> I agree that "Small" associations do not have the same needs as large associations and that they should be exempt from many aspects of the Davis-Stirling Act, or at least have the option to adopt certain aspects of the act, due to disproportionate administrative and cost issues.

Craig Stevens, Exhibit p. 16 (commenting on small nonresidential CIDs).

DEFINITION OF "SMALL ASSOCIATION"

Many of the comments address the question of how to define "small association."

Number of Units

Some of the commenters support a definition based on the number of units in a development. See Exhibit pp. 1 (Lynch), 3 (Dolnick), 8 (Haney), 16 (Stevens, commenting on small nonresidential CIDs).

In connection with that issue, Dick Preuss provided anecdotal data on the correlation between association size and the likelihood that an association is

professionally managed. In response to the staff's assertion that associations with 25 or fewer units would typically be unable to afford professional management, Mr. Preuss replied:

> In reality, few if any professional management companies can afford to manage associations that small, unless they are made up of expensive units with a sizeable annual operating budget. I would estimate that budget would have to approximate $125,000 or more to give full management services.
>
> A quick survey … of the Greater Los Angeles CAI Chapters' management company members, found that few will take on associations with fewer than fifty units, and some have a minimum of one hundred units.
>
> …
>
> I believe that twenty-five is too low a number and forty or fifty units is a better starting point in determining what constitutes a small association.

Email from Dick Preuss to Brian Hebert (Jan. 20, 2009).

Don Haney proposes a ceiling of 50 units for defining "small association." See Exhibit p. 8.

Craig Stevens proposes a ceiling of 100 units (with respect to nonresidential associations). See Exhibit p. 16.

Number of Units and Annual Revenue

Frank Roberts informally suggests that the definition could be based on a combination of unit size *and* annual income. For example "small association" might mean an association with fewer than 50 units *and* an annual income of less than $125,000. This would exclude associations that have few units but have sufficient funds to afford professional services.

Another possibility would be to use a standard based on either unit size *or* annual income. For example "small association" might mean an association with fewer than 50 units *or* an annual income of less than $125,000. This would include associations that have a large number of units but have financial resources that are too small to pay for professional services. (Steven Dyer notes that his association has 170 units, but an annual income of only $17,000. See Exhibit p. 13.)

Association Type

Steven Dyer proposes special treatment of a particular *type* of association: a planned unit development, where the common property consists entirely of

reciprocal easements for use of roads or water distribution systems. See Exhibit pp. 11-15.

Martin Gorfinkel makes a similar suggestion, arguing for special treatment of very small planned unit developments with minimal common area property. Email from Martin Gorfinkel to Brian Hebert (Jan. 29, 2009).

Those proposals are appreciated, but are beyond the scope of the current study, which is limited to consideration of distinctions based on *size*, rather than *type*. (Note that the Commission has specifically considered studying the application of the Davis-Stirling Common Interest Development Act to road maintenance associations, but has not yet commenced that study. See CLRC Memorandum 2008-40, p. 19.)

MEMBER ELECTION PROCEDURES

Several of the comments address member election procedures in CIDs.

Support for Simplifed Procedure

Nancy Lynch suggests that in-person voting would save time in her small association (7 units). See Exhibit p. 2.

Don Haney expresses general support for simplified election procedures. See Exhibit p. 8.

Craig Stevens writes in support of simplified in-person voting for small nonresidential associations. See Exhibit p. 16.

Ballot Secrecy

Some of the comments questioned the need for ballot secrecy.

Nancy Lynch notes that ballot secrecy can be illusory in very small associations, because it is often a simple matter to figure out how everyone voted. She provides an example of this in her 7 unit association. See Exhibit pp. 1-2.

Both Don Haney and Steven Dyer suggest that there are circumstances in which ballot secrecy is not necessary (e.g., when making minor technical amendments to governing documents). See Exhibit pp. 8, 14.

Nomination and Write-In Candidates

Steven Dyer discusses problems with the nomination and write-in provisions in the existing election statute. His comments seem to be aimed more at reforming the general election provisions than at developing an alternative

procedure for small associations. See Exhibit p. 14. To the extent that is the case, his proposal is appreciated, but beyond the scope of the current study.

Nonetheless, it is worth considering how the draft of a simplified election procedure for small associations (presented in Memorandum 2009-14 at p. 10) would address the issues raised by Mr. Dyer:

- The option of nominating a candidate from the floor is expressly authorized in that draft and so would not present any problem.
- The option of writing in a candidate's name on a ballot is not addressed in the draft.

The Commission should consider revising the draft to expressly authorize write-in candidate voting.

OTHER PROCEDURES

In addition to discussing election procedures, some of the comments address other aspects of CID statutory law.

Both Samuel Dolnick and Don Haney propose a graduated system of accounting requirements, with larger associations having more rigorous requirements. See Exhibit pp. 3-6, 8-9.

Steven Dyer proposes simplifying the reserve study requirements applicable to some small associations. See Exhibit p. 15. He relates an incident where the cost of a professional reserve study for a six unit association exceeded 20% of the association's annual budget. *Id.* n.3.

The staff appreciates receiving these proposals and will note them for consideration in a later phase of this study, when the Commission examines the statutory accounting rules applicable to small associations.

Respectfully submitted,

Brian Hebert
Executive Secretary

January 21, 2009

Mr. Brian Hebert
California Law Revision Commission

RE: Memorandum 2009-14

I believe that the number of units in an association is the best measurement in what constitutes a small homeowner's association. If the purpose is to simplify the requirements for small associations, then the number of units is the only factor that matters since all the operations of the association have to be performed by a limited number of persons.

As a permanent absentee voter, I strongly disagree to the statement that the "election process is expressly modeled after the absentee ballot process used by county election registrars". My most recent ballot in our November 4, 2008 election was inserted directly into an envelope that I had to sign and identify my voting address on record. Whoever opened that envelope would know how I voted. That is very dissimilar to association elections since, in association elections, the ballot itself is place in an unmarked envelope and that envelope is inserted into another envelope that is signed by the homeowner.

I would like to address election procedures in smaller homeowner associations. We are a 7 unit association. Due to our small size, we elect 4 directors who are also the officers. Since we have a limited number of residents, most of the homeowners have been willing to serve on the board for a few years and then find another homeowner to take their position when they grow weary of the work. Up until our 2008 elections, we never had more than 4 candidates in any given year who wanted to serve on the board. Any homeowner who was willing to take on the job of a board member could have the position and the homeowners would unanimously approve them. We did not use secret written ballots until 2007 and it wasn't really secret in 2007 since only 4 candidates were willing to take the 4 board positions. If you want to do the work, the homeowners will vote for you.

In 2008, the position of secretary became available due to our former secretary of 3 years tiring of the position. Our election was conducted in accordance with the law using secret written ballots. All 7 homeowners returned their ballots. The outgoing board has only 3 of the 7 homeowner votes. The incoming board still has only 3 of the 7 homeowner votes. We also have space for a write in candidate for each position although no homeowner wrote in a candidate.

EX 1

Now, I will provide you with the detailed election results identifying each household only as homeowners 1 thru 7. I did not ask any homeowner how they voted. I also am not guessing at how they voted.

	Votes received
Candidate 1- President	6
Candidate 2- Vice President	6
Candidate 3- Treasurer	6
Candidate 4- Secretary	5
Candidate 5- Secretary	2

Homeowner's 2 thru 6 voted for candidates 1 thru 4.
Homeowner 7 voted for candidates 1, 2, 3 and 5.
Homeowner 1 voted only for candidate 5. (Homeowner 1 is candidate 5.)

I obviously know the names of homeowners 1 thru 7, so I know how everyone voted as does every other homeowner in our association. How is this secret? Just by virtue of the fact that we use secret written ballots, our election results will never be a secret due to our size.

We also used secret written ballots to pass amendments to our bylaws this year. Homeowner's 2 thru 6 voted in favor of passing the amendments. Homeowner's 1 and 7 did not return their ballots. What's the point in using a secret written ballot when the results will never be a secret? If they aren't secret in a 7 unit association, they could never be secret in an association less than 7 units.

In-person voting in our small association would save us some time, although the results will still not be secret. There is a significant difference in a 7 unit vs. a 25 unit association. At a certain size association, secrecy could be attained. I hope you hear from other size associations on this issue.

I know the commission has received comments from others that imply smaller associations have contempt for the law. Our association does not have contempt for the law. We simply are asking that the law be reasonable and equitable. It presently is neither.

Nancy Lynch
Mountain View, CA

EX 2

SAMUEL L. DOLNICK
5706 Baltimore Drive #348
La Mesa, CA 91942-1654
Phone/Fax 619-697-4854

January 24, 2009

Mr. Brian Hebert, Executive Secretary
California Law Revision Commission
4000 Middlefield Road, Room D-1
Palo Alto, CA 94303-4739

Via e-mail: bhebert@clrc.ca.gov
Attachment

Re: Study H-857; Memorandum 2009-14, dated January 15, 2009

Dear Mr. Hebert:

The investigation by the Commission into the separation of "small" and "large" associations in common interest developments (CIDs) is long overdue and is very welcome. The issue presented is whether or not the differences should be based on association revenues or on the number of separate interests.

The Commission rightfully states: "CIDs vary widely in size, from a handful of separate interests to over ten thousand separate interests. For the most part, existing law does not differentiate between CIDs of different sizes. That one-size-fits-all approach is problematic. Statutory requirements that make sense in a development the size of a small city may be unnecessary or unworkable in a development comprised of only a few homes." Two issues must be decided. The first is "What is meant by a 'small' association" and the second is whether or not the amount of association revenues or number of separate interests should be the criteria for differentiation.

Let me suggest that "[r]evenues as Measure of Association Size" be discarded for the reasons presented in the Memorandum (and other reasons I will list further); the number of separate interests in an association should be the basis for differentiation. Naturally, decisions will have to be made where the cutoff points will be. I am not qualified to render an opinion on that issue.

The reasons why revenues should not be the basis for differentiation follow. The purpose of Civil Code1365 is to codify fiscal matters such as annual financial statements and required disclosures, including reserves. Sub paragraph (c) is to make sure that some, but not all, of the yearly financial statements are examined by a licensed accountant to make sure the association's financial records are accurate; to prevent fraud, embezzlement and improper use of association's funds. Examination of association finances does not appear to be a logical basis for separating associations into "small" and "large" groupings. The statement that the definition of a "small" association would have to be periodically adjusted for inflation has no validity. An examination of a corporation's annual finances does not depend on increases in income due to inflation.

It is my considered opinion that CC §1365(c) has to be totally rewritten to properly protect the financial integrity of most CID associations. According to the Total Annual Revenue chart

on page 4, of the Memorandum, 53% of the associations have gross total revenues of under $75,000 and need not have any investigation of their annual financial statements. The material may be looked at by a board member, by a bookkeeper or some other non-licensee of the California Board of Accountancy. Whatever the board of directors decides is deemed sufficient. Is it logical to assume that their finances are all in order and that no one dips into the association funds for their own use? Who would know? The remaining 47% of the associations are only required to have an accountant (an independent accountant is not even required) *review* the annual financial statements. An *audit* is not even mentioned in 1365(c). Before a total rewrite of 1365(c) can be presented it is important to understand the differences between what a *review* and an *audit* actually are.

A *review* of the annual financial statement does not protect the association, or the homeowners, as the accountant accepts whatever financial documents the board of directors or management firm presents to him/her, no matter how inaccurate or inadequate. An independent examination as to the accuracy or validity of the material presented is not conducted in a *review.*

However, when an *audit* is conducted, the accountant examines, independently, the annual financial material presented. Independent examination is made of bank statements, income from assessments and other sources, validity of expenditures, whether minutes reflect approval of money spent, an examination of the reserve funds and many more items. While it is true than an *audit* is more expensive than a *review,* (the larger associations can absorb this expense) the extra cost is well worthwhile in an attempt to prevent fraud and embezzlement.

With an understanding of the differences between a *review* and an *audit* the following rewrite of 1365(c) is being presented.

Civil Code 1365(c) Within 120 days after the end of the fiscal year:
(1) The board of an association that receives up to twenty-five thousand dollars ($25,000) in gross revenues or receipts during the fiscal year shall prepare an annual financial statement.
(2) If an association receives between twenty-five thousand ($25,000) and two hundred thousand dollars ($200,000) in gross revenues or receipts during the fiscal year a **review** shall be conducted.
(3) If an association receives more than two hundred thousand dollars ($200,000) in gross revenues or receipts during the fiscal year an **audit** shall be conducted.
(4) Paragraphs (2) and (3) shall be conducted by a licensee of the California Board of Accountancy, who is independent from the association's managing agent, using generally accepted accounting principles.

The **current version** of 1365(c) already provides for two tiers of annual financial statements. The first tier, from zero dollars ($0.00) to seventy-five thousand dollars ($75,000) only requires that the board of an association "shall prepare an annual financial statement." There is no oversight by any independent agency. According to page 4 of the Memorandum, referred to above, this means that 53% of the associations, more than half, do not have an independent examination of their finances.

In the **proposed change**, this first tier is reduced to twenty-five thousand dollars ($25,000) so that only 24% of the associations are not required to have independent oversight.

The second tier of the **current version** of 1365(c) provides for a review for any association having gross revenues of seventy-five thousand dollars ($75,000) or more. This affects the remaining 47% of the associations including those that have gross revenues in excess of half a million dollars ($500,000). This amount of money is enticing to a certain percent of individuals if an independent examination is not made of the finances.

The second tier of the **proposed change** consists of 52% of an association's annual gross revenues of twenty-five thousand dollars ($25,000) to two hundred thousand dollars ($200,000); an association would be required to have an independent review of their annual finances. Note that a person independent from the managing firms accounting department is to perform the independent examination. The reason for the preceding sentence is that an accountant who is paid by the managing agent to do the managing agent's books and financial statement, in addition to doing the books and annual financial report for the managing agent's associations is serving two clients intimately bound to each other. This is a conflict of interest.

The **current version** of 1365(c) does not provide for a third tier, however, the **proposed change** does. An association that has annual gross revenues or receipts of more than two hundred thousand dollars ($200,000) would affect 24% of the associations. There are many associations that have gross annual income of more than 1 or 2 million dollars plus millions of dollars in their reserve funds. These associations would have to have an audit of their annual finances.

As I am not an attorney and have little experience in writing legislation, the **proposed changes** embodied in the four paragraphs of 1365(c) noted above may have to be rewritten to conform to statutory language.

The chart on page 4 of the Memorandum, with changes, would be refigured as shown.

Annual Revenue (in thousands)	**Percentage of the Whole**	**Cumulative Percentage**	
0-25	**24%**	**24%**	(no review or audit necessary)
25-200	**52%**	**76%**	(review necessary)
200 +	**24%**	**100%**	(audit necessary)

As a 40 year homeowner in a CID, 10 years in Chicago, Illinois and 30 years in California, I am appalled as to the lack of financial oversight provided by the California legislature, when the legislature attempts to micromanage CIDs in all other areas. It is estimated that CIDs in California have control in excess of **7.4 billion dollars;** certainly since the legislature has created the statutory basis for CIDs, they should also set up a procedure for oversight so that

associations and the owners of the separate interest are protected. After all, members of the board are volunteers and not professionals.

Thank you for your attention to this matter. It is my hope that some of the above suggestions will be incorporated in Study H-857, Memorandum 2009-14.

Very respectfully yours,

Sam Dolnick, Senior Condo Owner

Memorandum

TO: Brian Hebert, Executive Secretary, CLRC

From: Donald W. Haney, CPA, MBA, MS (Tax)
Email: dw@haneyinc.com
Phone: 888.786.6000 x325

COPY: Other interested parties

Date: January 24, 2009

SUBJECT: **Memo 2009-14 Small Associations**

Request for Comments

In your Memorandum 2009-14 you propose the concept that "Small Associations" should be exempt from certain compliance standards imbedded in the current Davis Stirling Act and the proposed CLRC restatement. You asked for comments regarding this concept in general and the election rules specifically. You have also asked about the exemptions accorded "Commercial CIDs."

Underlying Beliefs and Assumptions

Before I comment in detail, I will disclose the beliefs and assumptions upon which my comments are constructed. Therefore, my biases will be available for other commentators as they evaluate this response.

1. There is a clear tension in this body of law between two fundamental views:
    a. The CID as a governmental body that should operate using the public governmental unit model; and
    b. The CID as a corporate business entity developed to maintain, protect and enhance corporate assets that should operate using the corporate governance model.

    My bias is toward the corporate model. The California legislature leans toward the governmental model.
2. In my over 30 years of observing the legislative process develop this body of law I would label their work – reactionary. The typical life cycle of new legislation in this area is:
    a. One unit owner, real estate agent, association, new buyer etc. complains about some real or perceived "wrong" perpetuated upon it by the association or its agents;
    b. The legislative body reacts to this situation by adopting some new "cure" to the existing law to make sure that this wrong will never happen to any community again;
    c. The other 40,000 plus CIDs must now comply with this new requirement at some financial and emotional cost whether or not the problem exists or is likely to exist in their community; Therefore,
    d. I am a strong supporter of the CLRC's work to bring some order and rationality to this body of law.
3. I believe that the law should promote transparency of operations, informed consent by unit owners, and ascertainable standards to which various stakeholders can be held accountable. It is also challenging to make sure that laws do not triumph over good judgment and changed conditions (A required two signatures on a checks when checks no longer exist).

Small Association Exemptions – In General

In general I support the notion that there should be some type of gradient compliance system. The one size fits all model is clearly costly and inappropriate in many cases. The commission may want to consider "opt in" compliance options driven by individual situations. For example if a percentage (say 10% or two owners whichever is larger) of owners request a higher than the minimum standard of care on some issue, then the association should be required to comply with that higher standard.

I also agree that unit size not individual revenues should determine which compliance rule applies. I believe that 50 units would be a more effective boundary for burdensome bureaucratic processes.

The voting issue – In particular

As a business person the current voting rules are a clear example of the Gordian knot (an intractable problem) created when trying to meld the government secret ballot model with the corporate proxy voting model. In the corporate world a shareholder fills out its annual proxy statement, applies his/her/its signature to the document, puts it in an envelope and sends it to the designated vote counter. Nobody cares about "secret." It is my experience that many smaller communities have a tough time just getting qualified people to serve on the board let alone agonizing over who voted for whom. I know that this comment will create righteous indignation among some true believers. I also acknowledge that in some rare situations "secret ballots" may be necessary and appropriate. However, in the vast majority of association situations it is much ado about nothing of consequence. Therefore, I support voting simplification for small associations and I trust your team to develop the simplified process.

Other Gradient Options - Finance

I assume that sooner or later you will get to the finance compliance issues. In August of 2006 I submitted to you the following suggestions regarding the annual financial reports. I repeat them here for your consideration and the benefit of your new audience.

The Section 4805 language consists of "cut and pastes" from obsolete Corporation Code language and creates some conflicts with Section 5500. The $75,000 trigger was put in place in the early 80's in response to a push by the California Association of Realtors. The dollar level response was done in a hurry at the time. What follows is an attempt set boundaries and requirements based upon units and not dollars and make the language consist with current accounting standards

Start 4805

§4805. (a) Every association shall prepare an annual accrual basis financial report in at least 12 point type font and deliver it to all members within 120 days after the end of its accounting year at no cost to the member. The association may charge a reasonable fee for additional member requested copies. Unless the association's governing documents call for higher standards the annual accrual basis financial report shall be prepared in accordance with the following minimum standards:

(1) For associations with ten (10) or less units the financial report shall at least include a balance sheet, a cash flow statement, a revenue and expense statement, and a report by an authorized association officer that comments upon the association's financial condition and that states that the report was prepared by the association from its books and record without review or audit by independent accountants.

(2) For associations with more than ten (10) and equal to or less than seventy-five (75) units the annual financial report shall be compiled with full disclosure by a licensee of the California Board of Accountancy in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

(3) For associations with more than seventy-five (75) and equal to or less than two hundred fifty (250) units the annual financial report shall be reviewed by a licensee of the California Board of Accountancy in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

(4) For associations with more than two hundred fifty (250) units the annual financial report shall be audited by a licensee of the California Board of Accountancy in accordance auditing standards generally accepted in the United States of America.

(b) The annual report shall include any disclosures required by Corporations Code Section 8322 - Annual statement of transactions with interested persons and indemnification.

End 4805

These standards are cost effective for the association; provide an appropriate level of disclosure and oversight; use language consistent with current CPA standards; and are independent from monetary inflation. The $10,000 floor in the Corporations Code was established many years ago (I think 1978) and has not been updated since. A ten unit community with $200 per month assessments will have annual assessments of $24,000. The unit count boundaries are suggestions only. These suggested changes only modernize certain terms, establish clear boundaries, reduce costs for many associations, and are consistent with the meaning, motive and intent of the current law. Except for arguments about unit boundaries, they should not be too controversial.

Current accounting standards require any "related party" transactions to be disclosed. Therefore, the Section 8322 requirement may not be required.

I will save the discussion of the Budget and Major Repair and Replacement discussion for another day. However, these are key "informed consent" disclosures for all CIDs.

Commercial CIDs

The common basis for exempting commercial CIDs from a number of Davis-Stirling Act (the Act) provisions is the anecdotal notion that owners and directors in these communities are more sophisticated and do not need the consumer protection provisions imbedded in the Act. I am unaware of any research that validates this postulate.

Our firm has been involved with a number of different commercial CIDs over the years. I can assert without reservation that these owners and their directors are no more sophisticated in their awareness of CID operational, finance and governance issues than their residential counterparts. In fact, one could make the case that they are less functional than their residential counterparts at maintaining their facilities, financing the operation, governing and informing new buyers about their situation just because they are exempt from some of the compliance requirements.

If I were responsible for the decision, I would not exempt commercial CIDs from any statutory compliance duties.

Closing comments

I was disappointed to learn that reintroduction of this restatement would be put off for another year. I am guessing that the legal group's delayed response contributed to this decision. Many of these attorneys are long time professional colleagues and I respect their contributions over the years. But, please be careful about their nit picking this thing to death. While there are always transition issues associated with such a major restatement, I am unaware of any game changing revisions in your existing work product.

You and your staff have done a great job with the restatement and the big idea here is to get over to this new platform as soon as possible. After we get there, we can tidy up any real or perceived "loose ends." After all that is done, maybe CLRC will be able to address the two major crises's facing California CIDs – the assessment collection problem[1] and the vast underfunding of Major Repair and Replacement obligations.

[1] Help in this area should be fairly simple. All that is required is a few minor changes to the small claims act and a clear law with appropriate sanctions that requires CID owners to provide certain "unsecured creditor" information to the CID upon request.

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January 27, 2009

OUR FILE NO.

Via Electronic & Regular Mail

Brian Hebert
California Law Revision Commission
4000 Middlefield Road, Room D-1
Palo Alto, CA 94303-4739

Re: Study of the Legislation Relating to Common Interest Developments

Dear Mr. Hebert:

Thank you for forwarding Memorandum 2009 – 14. I was pleased to hear that the Commission staff will study the application of the Davis-Stirling Act to "small associations".

The Commission's acknowledgment that application of a "one-size-fits-all" statutory scheme can create problems for small common interest developments is very important. The memorandum notes that 51% of the common interest developments in California have twenty five or less separate interests. I have not read the publication which is the source for this figure. However, I wonder whether the table on page 4 of Memorandum 2009 - 14 includes associations that have been formed to maintain private roads and small water associations that are not mutual water companies. As will be set forth below, I recommend that the Commission consider whether private water and road associations should be treated as common interest developments that are subject to the Act.

Memorandum 2009-14 discusses how some of the requirements in the Davis-Stirling Act can be very burdensome for small associations. That is certainly correct insofar as the demand which is placed on association revenues. However, the Act may also discourage people from serving as directors of their homeowners association. I believe that because it frequently is difficult to find people who are willing to volunteer on behalf of their neighborhood. Recent changes to the Act have substantially increased duties of the board of directors and the tasks which the association must perform. While a master planned community might be able to afford professional management that is not the case with small associations.

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Therefore, I believe it would be very beneficial if the owners in small associations or those with a limited function were relieved from some of the requirements set forth in these statutes or such associations were subject to a less onerous and costly manner of voting, keeping records of reserves, etc.

The Definition of a Planned Development

Civil Code section 1351(k) defines the term "planned development". One of the elements of this definition is that either the association or the owners of separate interest own the common area. Civil Code section 1351(k)(1). Alternatively, a planned development can exist if the association or the owners of separate interests are empowered to enforce obligations by means of an assessment which may become a lien on the separate interests. Civil Code section 1351(k)(2). "Common area" (which is defined in Civil Code section 1351(b)) in a planned development includes "mutual or reciprocal easement rights [that are] appurtenant to the separate interests".

In rural areas of the State, associations that have been formed solely to maintain roads are very common; there are many examples of this in Monterey County. Likewise there are small water associations which are not mutual water companies. Because Section 1351(b) states that the common area can consist of mutual or reciprocal easement rights, shared rights to use a private road or a water tank and pipelines may constitute a "planned development". If the owners, whether individually or through an association, share the right to use a road or a water system, then their lots may fall within the term "planned development".

Many of these associations were formed before the legislature passed the Davis-Stirling Act, but there are undoubtedly others which have been created over the last twenty-four years. Regardless, I suspect that the lot owners who have entered into such agreements after 1985, and their legal counsel, did not realize that they could be subject to the Davis-Stirling statutory scheme.

Relieving Water and Road Associations from Compliance with the Davis-Stirling Act

There are probably several ways of addressing this situation including:

1. Amending the third sentence in Civil Code section 1351(b) to exclude shared easements over private roads or for water systems.

2. Adding a subpart to Civil Code section 1351(k) which states that term "common area" does not include shared rights in private roads or a well or water system if those are the only property interests that the owners of separate interests share.

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3. Amending Civil Code section 1374 by adding language similar to the following:

"For purpose of this statute, the term common area does not include: a development where the only common interests are the shared rights to use roads and/or wells and a water system."

I do not believe this situation is easily resolved as long as an association has no power to lien the separate interest of its members because the statutory definition of common area includes "mutual or reciprocal easement rights". If there are rights over a private road or to use a well, the association may be a "planned development" under Civil Code section 1351(k)(1).

"Small Associations"

The staff memorandum suggests amending Civil Code section 1351 to define a "small association"[1]. That may be a good starting point. However, it is not the only criteria for creating a reduced level of scrutiny of developments that have very limited common area.

There are some associations with more than 25 separate interests where applying the application of the Davis-Stirling Act requirements makes sense. The development in which I have lived for over 30 years is a good example; it is a subdivision consisting of more than 170 lots without any common area improvements. The County maintains the streets and water is provided by a public utility. The developer of our subdivision did not construct any of the homes and the only land which the association is charged to maintain are greenbelt areas, where the association takes steps to reduce the risk of a wildland fire. Under our CC&R's the present level of assessment is $100 per year[2].

Therefore, I suggest that the Commission study each of the statutes in the Act in order to determine which requirements are essential where the separate interests consist of single family lots and there are no significant common area improvements.

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1 I suspect few small water associations which are not mutual water companies, have more than twenty-five members. Therefore, proposed Civil Code section 1351(m) may be sufficient to exclude water associations from the Act. I know there are private road associations which have more than twenty-five members so the new language may not help them.

2 Significantly, this figure is much lower than the lowest aggregate assessment amount that is referred to on page 2 of Memorandum 2009-14.

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The Requirement for a Secret Ballot

Civil Code section 1363.03(b) identifies four instances (viz. voting for election and removal of members of a board of directors, action on assessments that require a vote of the association membership, grant of an exclusive use common area and voting on amendments to the governing documents) where voting must be by a secret ballot. Memorandum 2009 – 14 correctly points out how the secret ballot requirement can cause problems when one member of an association holds a proxy from another. There is another unfortunate aspect of Section 1363.03; the language in Section 1363.03(j) provides that the association may adopt rules to allow nominations from the floor of membership meetings and "write-in candidates". However, the statute does not require that floor nominations be permitted nor does Section 1363.03(j) give any guidance on how to do that. Therefore, the current wording of Civil Code section 1363.03 may discourage floor nominations and write-in ballots, and I do not believe that is wise.

Assuming there is a compelling reason to maintain the requirement for a secret ballot, I believe there are several reasons why using secret ballots to vote on amendments to the governing documents should not be mandatory.

First, some modifications to governing documents are not of such magnitude to require secret ballots. Changing the dates of membership or directors meetings is a good example.

Second, it is possible that during a meeting of the association membership, the owners of the separate interests may decide it would be appropriate to modify the language of a proposed amendment to the governing documents for technical or clarification grounds or to clarify language. Requiring that all amendments of governing documents must be secret ballot would eliminate the flexibility to do this.

A third instance is where the governing documents state that a super majority (e.g., two-thirds or three quarters of the total membership) must consent to the changes. From personal experiences, I can tell you that obtaining approval by seventy-five percent of the membership is not easy.

Nevertheless, I could understand maintaining a secret ballot requirement for amendments to the governing documents on matters such as: changes in the number of directors or the permitted use of the property in the development; alteration of the common area; or modifying language in a Declaration of Covenants, Conditions and Restrictions which fixes voting requirements on certain subjects (e.g., modifications to the common area).

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Excluding Small Developments from Other Statutory Requirements

There are other statutes in the Act which create a heavy burden on small associations or those with limited common area. For example, Sections 1365, 1365.2.5 and 1365.5, which require that a study be made of association reserves for replacement of common area improvements[3], can be an unnecessary drain on an association's budget.

I recognize it may be appropriate to apply statutes that give certain protections (e.g., the requirement to deliver the notice pertaining to assessments and foreclosures set forth in Civil Code section 1365.1, the mechanism for creating and enforcing liens which is addressed in Sections 1367 and 1367.1, 1367.4 and 1367.5, and the prohibition on excessive assessments set forth in Civil Code section 1366.1) to lot owners in road or water associations or to a development with a very limited common area. However, it should not be necessary to require that any association of property owners who share the right to use a road, a water system, or greenbelt areas to becoming a common interest development and therefore subject to all of the provisions set forth in the Davis-Stirling Act.

I appreciate the opportunity to communicate with you concerning this matter.

Very truly yours,

Stephen W. Dyer

SWD/dkp

cc: David M. Van Atta, Esq.
William G. Priest, Jr., Esq.
Paul D. Gullion, Esq.
Craig Stevens

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3 I have heard of one instance which illustrates the unfortunate impact of this requirement on an association that consisted of six units. When the directors asked a vendor for an estimate to make a reserve study, the quoted figure exceeded 20% of the association's annual budget.

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EMAIL FROM CRAIG T. STEVENS, MAR WEST REAL ESTATE (1/27/09)

Brian,

Once again, thank you for your team's efforts to clean up California law relative to CID's. Regarding your request for comment on the topic of "Small" Associations, I submit the following suggestions.

Please note that my comments are only relevant to non-residential associations.

1) I agree that "Small" associations do not have the same needs as large associations and that they should be exempt from many aspects of the Davis-Stirling Act, or at least have the option to adopt certain aspects of the act, due to disproportionate administrative and cost issues.

2) "Small" associations should be defined as 100 or less Parcels/buildings/units for non-residential associations. The general desire of owners in non-residential associations is to keep the scope, administration and costs as low as possible. Non-residential associations do not generally have the same types of issues as residential and usually only a small portion of the owner population involves themselves in association meetings and matters on an on-going basis.

3) Most all Non-Residential associations are "small" associations, therefore, the non-residential project you are working on should be coordinated with this project.

4) Small associations should not be burdened by 1363.03 relative to Elections. The use of a secret ballot completed at the meeting and folded in half and handed to the board or management company, or the use of a proxy, submitted to the board or the management company in advance of the meeting, is sufficient, efficient and cost effective. Small associations should be given the option to adopt more stringent requirements, including those included in 1363.03 now.

I will be sending my comments on the non-residential CID project to you next week. Many of those comments dove tail with these comments.

Thank you for allowing me to participate in the process.

Craig

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